

## The CNE Growth Commission for Puerto Rico: Proposed Notes Towards an Agenda<sup>1</sup>

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### Vision and Rationale

Devising economic development opportunities for Puerto Rico and strengthening execution capabilities are the most pressing goals for policymakers in Puerto Rico and the United States, given the structural and prolonged nature of the socioeconomic crisis faced by the island's residents and the economic and administrative ties between the territory and the mainland.

Achieving long-term, sustainable economic growth and development is a complex endeavor that requires a new set of strategies and the rebuilding of institutions; thus, there are no quick fixes or silver bullets.<sup>2</sup> As a first step in charting this road towards sustainable economic development, the Center for a New Economy (CNE)—Puerto Rico's only independent, non-profit think tank—has undertaken the task of conforming the CNE Growth Commission for Puerto Rico (the "CNE GC"). The CNE GC will identify opportunities and innovative strategies that can disrupt the pernicious pattern of economic decline, weak governance, policymaking, and assessment, and embark on a new path to foster long-term growth. Its primary goal is to develop a framework and process to: identify relevant issues, perform analyses employing apt methodologies, provide recommendations, and help devise a diversified portfolio of growth-inducing activities and the costs and oversight required for their execution.

Our vision is based on the premise that long-term sustained economic growth is a result of a country's capability to progressively move into higher value-added activities. This is achieved by improving the types and quality of the goods and services produced and by finding innovative and more efficient ways of producing them. This is especially true in the 21<sup>st</sup> century, which is characterized by ever-deeper inroads into a knowledge-based economy and by heightened global competition. Therefore, any new economic strategy for long-term growth ought to be focused on:

- (1) Speeding up the process of economic structural change by advancing the economy's insertion in high-value niches, investing in innovation, and adopting new knowledge and technologies; and
- (2) Creating the institutional framework to promote this structural change; that is, *revamping* the institutions whose mission is to promote this transformation.

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<sup>2</sup> Indeed, past efforts have failed mainly due to a failure to understand the complexity of such process. It requires, for example, building realistic goals and management execution capabilities for economic development institutions, such as revamping competition policy and its enforcement and structural access to credit, improving the regulatory and fiscal toolkit of exemptions, credits and deductions, and strengthening the research and innovation ecosystem with pragmatism within uncharted and adverse fiscal consolidation process.

- (3) Devising public policies that help raise the wellbeing of society in an inclusive manner, so that most of its members can benefit from the gains of improved economic performance.

An important element to keep in mind in the case of Puerto Rico (as well as in many other middle-income countries) is that the capability of the government to implement its development strategies, policies, and programs, as well as to provide continuity to these, is a key constraint. This is because the scale and complexity of the organizational tasks required to sustain and advance a modern economy intensifies as societies grow and become more complex (Andrews et al 2015).<sup>3</sup> Therefore, developing the capabilities for private actors and the government to work together towards these objectives is a key component of any proposed growth and development agenda.

## Objectives

One of the primary objectives of the CNE Growth Commission is to identify and produce the relevant analyses, policy designs and, in certain instances, demonstration projects to improve economic and social policy decision-making suited for Puerto Rico's context. These exercises should advance the creation and institutionalization of *learning cycles* via sustained collaborations between government policy-makers, practitioners, and key stakeholders in academia the NGO community, and the private sector.<sup>4</sup>

A second objective of the CNE Growth Commission will be to use the knowledge gained from these demonstration schemes and analytical exercises as a platform to influence policy decision-making in Puerto Rico and Washington DC.

There are an important set of caveats that we need to keep in mind. First, as an independent commission, the CNE GC relies on a limited amount of resources and influence to carry out its objectives. Generating sustained, long-term growth and development requires a multifaceted, resourceful and lasting strategy—often headed and supported by government. Thus, the approach relies on identifying a discrete set of projects that are relevant to Puerto Rico and can help us lay the groundwork and demonstrate a viable pathway for a broader and sustained effort. Second, our work needs to acknowledge the current political and macroeconomic instability, and the government's limited access to capital, which will make any endeavor a more complex one. The Commission believes that its proposed approach will contribute to build consensus on achievable development goals and increase the quality of policy debate.

## A Proposed Agenda and Structure

**Note:** *This is an initial proposal to members of the Commission designed to spur constructive conversations and define next steps.*

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<sup>3</sup> For example, business and labor regulations, education and workforce development, energy infrastructure, effective taxation, pension systems, public health, environmental management, transport systems.

<sup>4</sup> The learning cycle aims to create a process through which we can institutionalize learning and effective change. We conceptualize the cycle as one following efforts of other international groups and organizations aiming at creating change by developing state capabilities to doing so (e.g., Andrews et al 2015): identify and diagnose challenges/problems; contextualize potential solutions using existing evidence; design and implement innovations; evaluate them using rigorous scientific methods; use this evidence generated to inform the solution of the challenge.

The Commission's projects will work towards (1) identifying and suggesting ways to relax local and external constraints that inhibit the territory from speeding up the process of economic structural change towards higher productivity activities; and (2) generate opportunities to diversify the portfolio of high productivity activities in the economy. Because these constraints and opportunities are embedded in Puerto Rico's pre-existing economic, business, and institutional/organizational structure, these exercises will benefit substantially from using rigorous, state-of-the-art analyses.

The proposed undertakings will focus on a subset of areas with potential for high impact: private sector development policy; macro-fiscal policy; human capital and workforce development; and energy and other critical infrastructure. Working Groups, composed of representatives of the (local/multinational) private sector, academics, policy makers, and other key stakeholders from the civic sector, will be defined under each area in order to confirm critical matters, points of strength and resiliency, opportunities, effectively leverage relevant expertise, and help build broad support for reforms.

## Area 1: Productive Development Policies

The strategy to determine Puerto Rico's capabilities to progressively move into higher value-added activities and improve productivity across sectors of the economy will require a rigorous diagnostic analysis. This will help determine an *ex ante* optimal research portfolio to be built for purposes of industrial promotion activities. This resulting process will require specifically building realistic goals and management execution capabilities for the institutions of economic development in the territory.<sup>5,6</sup>

Though improvements in high value activities are critical for both local and export markets, granting priority to tradeable goods and services by local and multinational investment should be a priority when aligning the required policy toolkit, for purposes of supporting current advantageous activities and enhancing future resiliency.<sup>7</sup> Moreover, understanding the relative position of tradable goods and services within their product/knowledge/regulatory frontiers, global value chains, labor requirements, access to capital, investment (dis)incentives, and leveraging of the innovation ecosystem will be crucial in this endeavor.

A Working Group of the Commission will conduct a diagnosis of opportunities, which will evolve out of three inter-related analyses:

- *Dialogues with sectorial leaders*

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<sup>5</sup> For example, revamping competition policy and its enforcement, structural access to credit, improving the regulatory and fiscal toolkit of exemptions, credits and deductions, and strengthening the research and innovation ecosystem.

<sup>6</sup> Caveat: At present, key public institutions such as the PR Industrial Development Company, PR Science and Technology Trust, Government Development Bank, Economic Development Bank, have depleted their assets and funding independence and lack experienced executives, while fiscal and competition components are controlled by institutions outside the economic development arena (i.e., Department of the Treasury on tax regime for multinationals, emerging and existing businesses; Department of Justice on competition policy).

<sup>7</sup> Note for GB: Except for the concurrent \$7BN biologics investment by Amgen, Lilly and Abbott during the 2001-2003 period and limited examples of export services building on biopharma, the bubble period drew capital into real estate, retail trade and local services rather than local private investment into export of goods and services. See analysis of boom and bust of small/midsize taxable corporate taxpayers.

A series of *interviews, field visits, and dialogues* with local business leaders, offshore managers and investors, service providers, and representatives from trade unions and NGOs in Puerto Rico have been conducted to take stock of institutional capabilities, identify processes through which private and public actors work together, and detect key stakeholders that can discover new mechanisms and opportunities to strengthen public governance and institutional structures, facilitate policy implementation, and improve the measurement of outcomes. Recommendations stemming from the dialogues will also help define specific projects and interventions focused on key productive sectors. Through initial dialogues with industry representatives and members of the Commission, we have identified interest to more intensive study opportunities in: (i) pharmaceuticals / biomedical engineering / medical devices; (ii) food processing and agriculture; (iii) aerospace engineering; and (iv) Information technology.

- *Evolution of Productivity and its Determinants*

Puerto Rico's economic development and competition agencies would benefit from a better understanding of the evolution of economic productivity, overall and across sectors of the economy, during the past decade (post-2005 period). Developing this knowledge is crucial since economic growth will depend more and more on gains in efficiency and productivity. Note that an increase in labor and overall (total factor) productivity would not be an end in itself, but a key mechanism to guarantee higher incomes and quality of life for the population.

More than just elaborating a diagnosis of the evolution of productivity, the aim is to make progress in identifying structural causes of (low) growth and explore potential policy reforms. Therefore, a first step towards a precise identification of these causes will be crucial to formulate public policies aimed at increasing productivity.<sup>8</sup> An important objective of these applied diagnostic analyses will be to build representative knowledge in the various dimensions discussed above regarding specific industries, to be determined, including new sectors and industries that have moved "up the value chain".

- *Identification of New Sectoral Ventures*

A cutting-edge methodology in productive development diagnostics, *product space analysis* can help identify new products and services that could augment aggregate value through the use of existing productive capabilities embedded in the island's current production structure. The methodology operationalizes the idea that it is generally easier for countries to move from products and services that they already produce to others higher in the value chain that are similar in terms of capital requirements, knowledge, and skills. Because not all feasible new products contribute in the same way to value added and growth, a key challenge along the diversification process is the identification of those goods/services that are feasible and have a higher potential to sustain economic development (Hausmann and Klinger 2007; Hausmann et al 2007; Hidalgo et al 2007; Fortunato et al 2015).

- *Product Market and Other Reforms to Improve Competitiveness*

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<sup>8</sup> Similar analyses have been performed in other contexts in joint efforts by government and academia. See for example, De Negri and Cavalcante (2014, 2015).

As highlighted in previous work, a feature of Puerto Rico's economy is the underdeveloped state of its private sector. The private sector employment rate in Puerto Rico is significantly lower than that in the U.S., and even fewer PR residents have firsthand experience—as owners or employees—in “free enterprise” organizations: private businesses that operate in the formal economy without large government subsidies, special tax breaks and regulatory advantages, or heavy-handed oversight by government bureaucracies. These observations point to some key challenges and concerns, such as a shortage of work experience, opportunities for learning on the job, and marketable skills among its labor force, in particular the management skills and business savvy required for a thriving entrepreneurial class (Davis and Rivera-Batiz 2006).

The work of the Commission should consider reforms of product (and other) market regulations to promote the growth and development of the private sector, such as state control of business enterprises, legal and administrative barriers to entrepreneurship, and barriers to international trade and investment, retail trade, network industries, and professional services (e.g., barriers to entry, operational restrictions, and price controls). In addition, there is a poor understanding of the (possibly very limited) extent of and enforcement of anti-trust policy in the territory. This generates the potential for a substantial degree of ineffectively regulated oligopolistic markets across many sectors of the economy.

- *Learning Scheme – Productive Development Institutions*

A second important objective is to develop a learning scheme with(in) government agencies entrusted to carry out economic development and the Treasury Department to generate reliable data and encourage its use in the determination of economic policy. Ideally, this agenda will help develop a partnership with the Puerto Rico Department of Economic Development: working with the Department to identify and learn from relevant evidence, to develop plans for new proposals, and to build capacity to implement effective public policies. The ulterior objective is to build and strengthen the capacity of their teams and help support evidence-based policymaking for development strategy purposes in the territory.<sup>9</sup>

This institutional upgrading process will also allow the Department of Economic Development to robustly justify priority funding of select economic development programs. Given the myriad constraints in a fiscal adjustment period, the government of Puerto Rico will need to establish a protected budget and assessment cycle for the Department and other agencies whose core functions are essential to carrying out development strategies.

## **Area 2: Macro-Fiscal Policy**

- *Pro-Competitiveness Tax Policy*

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<sup>9</sup> The aim of this development strategy is to address what economists highlight as “market failures” that may require active business policies – interventions that have differential effects on some economic activities over others. Some of the market failures include: (1) learning what new products can be produced profitably in an economy (self-discovery externalities); (2) decentralized markets are not good at coordinating new activities often require simultaneous and lumpy investments upstream and/or downstream (coordination externalities); and (3) the fact that private investments require highly specialized public inputs, such as accreditation, R&D, industry-specific infrastructure (e.g., transport), of which the government has little ex ante knowledge (missing public inputs). See Hausman, Rodrik, and Sabel (2008) for a thorough discussion.

A Working Group of the Commission will develop feasible proposals for tax policy reform with the aim of (i) enhancing the territory's competitiveness and (ii) reducing tax distortions that may inhibit productivity growth in the private sector. These analyses will recognize opportunities such as Puerto Rico's relative fiscal autonomy with regards to its income, consumption, and other (i.e., capital, labor) taxes—subject to current political and macroeconomic constraints—as well as current obstacles, such as perverse incentives for local capital to move into local market services and (risk/geographically constrained) tax-enhanced investments.

The Group will work on evaluating the potential for a *disciplined* fiscal reform to enhance the territory's competitiveness, given its inclusion in the US monetary union and thus its inability to take advantage of exchange rate policy to restore competitiveness. This is because given the structural macroeconomic shock suffered by Puerto Rico's economy (such as the elimination of US IRC Section 936), an exchange rate devaluation would be in theoretical terms a desirable policy response to restore competitiveness in the medium term.

Puerto Rico's fiscal autonomy provides a key advantage, as it can use unilateral fiscal policy to generate improvements in competitiveness similar to those following a nominal exchange rate devaluation, while keeping the nominal exchange rate fixed. Faced with the dramatic alternative of an austerity-based internal devaluation, many jurisdictions and countries have considered this option of a *fiscal devaluation*; and these have gained popularity in policy circles.<sup>10</sup> This can be achieved via a uniform increase in value-added taxes and reduction in payroll taxes—which roughly mimics an increase in import tariffs accompanied by an increase in export subsidies (Farhi, Gopinath, and Itskhoki 2013; Bosca, Doménech, and Ferri 2013; Auray, Eyquem, and Ma 2016).<sup>11</sup>

The analysis should also consider tax reforms to reduce distortions that may inhibit productivity growth in the private sector in the medium/long-run.

- *Other Macro-Fiscal and Public Credit/Debt Issues*

Puerto Rico's deep and prolonged recession has made the commonwealth's debt position unsustainable. In such a recessionary (demand-constrained) regime, demonstrated by the significant sub-utilization of its factors of production (i.e., labor, capital), an austerity-based internal devaluation would be suboptimal—both unfair and inefficient. This is because the government's current primary deficit implies that it will still need to take steps that would depress economic activity. As a result, there is a need for sustained financing of public deficit and structural reforms given these deep fiscal imbalance, population contraction, and lack of government access to credit. This will require a rigorous assessment of debt restricting needs that are necessary for restoring economic growth. (In progress: Debt sustainability analysis, M. Guzmán).

### **Area 3: Other Horizontal Reforms to Enhance Competitiveness**

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<sup>10</sup> See for example Cavallo and Cottani (2010) regarding Greece on VoxEU (<http://voxeu.org/article/greece-should-try-fiscal-devaluation-not-holiday-eurozone>).

<sup>11</sup> This can be implemented via increases in sales/VAT taxes, applying it uniformly across all goods and services produced in the economy; and allowing firms to expense payroll taxes fully against the VAT (guaranteeing the continued funding of social insurance obligations while rewarding the firms that comply with their payroll tax obligations) (See Cavallo and Cottani 2010).

The Commission's efforts will also identify opportunities for effective reform in areas with potential for high impact to enhance the competitiveness of (local and multinational) producers, such as tax and competition policy, human capital and workforce development, energy & CIT infrastructure.

- *Human Capital Investments and Workforce Development*

One of the key areas for any long-term development strategy in Puerto Rico is human capital, as it is closely connected to the productivity of its workforce and is essential in any initiatives to stimulate innovation and technical change. Human capital development largely involves educational and health investments, both of which have been closely linked to long-run economic growth and development.<sup>12</sup>

### *Public K-12 Education*

Although Puerto Rico has made significant strides in raising educational attainment, the quality of that education remains a major challenge and is reflected in the dismal academic achievement as measured by a number of local, national, and international assessments.<sup>13</sup> Significant efforts are required to improve the quality of education services in the territory, in particular for disadvantaged children in its public education system.<sup>14</sup>

A potential avenue for effective change is to create an *Educational Reform Research and Action Collaborative*: a partnership with organizations with proven success in improving educational outcomes, using rigorous evidence, to promote the creation of a learning system with(in) the Puerto Rico Department of Education. Again, the aim is to establish demonstration projects that can make inroads into the improvement of policy decision-making. Examples of successful approaches and collaborations between local governments, academia, and educational research organizations abound.

### *Graduate Research*

The productivity of researchers (graduate faculty and students) has a very important link to innovation and business creation and growth. It is unclear whether and how local and multinational firms leverage the existing tertiary education ecosystem. A Working Group of the Commission can study the potential for private sector development and growth that is and could be supported by the island's graduate research schools, given existing advantages, such as the ability to access US research funding institutions, leverage federal R&D tax credits, and protect intellectual property (IP) under US law.

A key output here would be to make a contribution for priority funding and incentives to graduate faculty given the restructuring and expected budget cuts of the public higher education system. These matters include strategic priorities areas for faculty management and recruitment, IP development and licensing, current and future demonstration projects with extension services to existing and new businesses, partnerships with non-Puerto Rico institutions, changes in the level and use of University of Puerto Rico indirect costs of competitive grants.

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<sup>12</sup> See Romer (1990), Hanushek (2013), Woessmann (2016) and Bloom, Canning and Fink (2014).

<sup>13</sup> See Ladd and Rivera-Batiz (2006), [Programme for International Student Assessment \(2015\)](#), META Results (2016), Chakrabarti, De Giorgi, Schuh (2016), and National Assessment of Educational Progress (2017)

<sup>14</sup> Any work effort within the PR Department of Education needs to acknowledge and address the PR Teachers' Pension Plan insolvency and its strategic fiscal priority.

## *Workforce Development*

Research should also be undertaken to evaluate current offerings and identify new initiatives focused on worker retraining and lifelong learning. The analysis should shed light on: the state of, global certification programs, demonstration projects (what works), fiscal treatment (deductibility by businesses and individuals), amongst other topics. Given the expected transformations in the tertiary educational system, certified training and vocational programs could provide alternatives to four-year colleges, and also stabilize revenues for higher education institutions already in existence.

## *Social Insurance Reform*

In recent years, numerous policy changes in the U.S. have sought to provide incentives for individuals in low-income households to work.<sup>15</sup> These reforms have been in large part a response to a growing urgency among policymakers to adopt social assistance programs that ensure a suitable safety net for families in distress, while still providing them with strong incentives to achieve self-sufficiency. Puerto Rico's social insurance programs, which have been criticized for creating work disincentives that contribute to the territory's dismally low labor force participation of working age adults—could benefit from a similar reform.

A Working Group of the Commission is currently studying whether a reform to the Temporary Assistance for Needy Families Program (TANF-C) based on providing earning supplements and improved access to a host of job-search assistance services can simultaneously reduce poverty, encourage steady work in the formal sector, and situate families on the path to self-sufficiency. The project aims to concurrently create work incentives while reducing (spatial and informational) search frictions in the labor market for adults in low-income families (via e.g. transport subsidies, skills certification, and training/support on how to make effective job applications (Abebe et al 2016).

This effort represents another example of an opportunity to create partnerships with organizations and researchers with proven success in improving developmental outcomes, using rigorous evidence, to promote the creation of a learning scheme with(in) the Administration of Socioeconomic Development of the Family (ADSEF) and the Department of the Family (DF). (In progress: G.J. Bobonis, F. Finan, M. Gonzalez-Navarro, D. Lamba-Nieves.)

- *Energy and CIT Infrastructure*

For the past seventy years, Puerto Rico has relied on an inefficient public utility primarily relying on oil to meet the vast majority of its energy needs. The recent economic crisis and the restructuring of PREPA have provided an opening to rethink an energy mix that has become unsustainable, both fiscally and environmentally.<sup>16</sup> A Working Group of the Commission will examine the feasibility of alternative energy supply scenarios that utilize the current restructuring opportunities to shift Puerto Rico's electricity supply to

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<sup>15</sup> The Earned Income Tax Credit Program is a notable example. See Nichols and Rothstein (2015) for a recent survey regarding the impacts of the EITC and Hoynes (2014) for a discussion and recent proposal for improvements to the program.

<sup>16</sup> Proposals by PREPA suggest a refitting of the existing power plant fleet to natural gas. While natural gas has lower carbon emissions and offers significant cost benefits over the use of oil in power generation, it nevertheless is an imported fossil energy source that will maintain Puerto Rico's energy dependence.

renewable sources. It will result in a clearer picture of the technical options, financial cost, and political obstacles to changing Puerto Rico's fuel mix from imported fossil fuels to locally generated renewable energy. (Deepak Lamba-Nieves & Jonas Nahm, Johns Hopkins University SAIS.)

Similar assessments should be carried out to identify ways of improving access to high speed internet and expanding investment in the island's communications and information technology infrastructure.

## Final Thoughts

This preliminary agenda represents an innovative and ambitious program, which aims to define a comprehensive development framework for the island and upgrade an outdated economic policy framework. The task will be difficult, as achieving sustained economic growth over the long-term is an extremely complex undertaking. The CNE Growth Commission for Puerto Rico, however, has the potential to help jumpstart growth and new opportunities amidst a prolonged crisis period, by carefully identifying and validating policies that lawmakers in Puerto Rico and Washington DC can implement to pave the way for sustainable long-term development. In this sense, it is possibly one of the most urgent and needed initiatives in the island's current policy agenda.

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